Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

FCC 93-453

In the Matter of:	)	
	)	
Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions between Carriers and Their Nonregulated Affiliates	)	CC Docket No. 93-251

NOTICE OF PROPOSED RULEMAKING

Adopted: September 23, 1993; **Released:** October 20, 1993

Comment Date: December 10, 1993
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By the Commission:

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I. INTRODUCTION

1. In this Notice of Proposed Rulemaking, we undertake a reevaluation of our affiliate transactions rules. Those rules, which were adopted in the Joint Cost proceeding,[1] set forth federal accounting requirements for transactions between carriers and their nonregulated affiliates. We propose to amend those rules to enhance our ability to keep carriers from imposing the costs of nonregulated activities on interstate ratepayers, and to keep ratepayers from being harmed by carrier imprudence.

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[1] Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities, Report and Order, CC Docket No. 86-111, 2 FCC Rcd 1298 (Joint Cost Order) recon., 2 FCC Rcd 6283 (1987) (Joint Cost Reconsideration Order), further recon., 3 FCC Rcd 6701 (1988) (Further Reconsideration Order), aff'd sub nom. Southwestern Bell Corp. v. FCC, 896 F.2d 1378 (D.C. Cir. 1990).

II. BACKGROUND

2. The affiliate transactions rules are part of the Uniform System of Accounts (USOA)[2] that the Commission has promulgated so that carriers will record their costs and revenues in a uniform and systematic manner. Generally, that system requires carriers to record as costs and revenues the actual amounts they pay to and are entitled to receive from their suppliers and customers. This approach, however, does not protect ratepayers when carriers deal with their affiliates. Because affiliate transactions occur at less than arm's length, the amounts affiliates pay each other for assets and services are poor indicators of the transactions' underlying value.

3. The Commission has long recognized the problems inherent in valuing affiliate transactions.[3] Originally, the Commission addressed these problems by restricting the USOA accounts used in interstate ratemaking to "just and reasonable" charges and by relying on the ratemaking process to particularize the meaning of that standard.[4] This resulted in two tests for assessing the reasonableness of the amounts carriers paid for affiliate transactions. The first focused on the overall earnings of nonregulated affiliates. Under this test, an affiliate's overall rate of return would be deemed excessive to the extent its five-year average exceeded that permitted the carrier. The second focused on the amounts nonregulated affiliates charged carriers for specific equipment. Under this test, the individual amounts would be deemed excessive to the extent they exceeded competitive benchmarks, as determined by sales or leases of comparable goods and services.[5]

4. In the Joint Cost proceeding, the Commission adopted the present affiliate transactions rules as part of a comprehensive effort to improve the safeguards against improper cross-subsidization. These rules set forth specific methods that all dominant interexchange carriers (IXCs) and local exchange carriers (LECs) other than average schedule companies must use in determining the amounts to record in USOA accounts for affiliate

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[2] 47 C.F.R. Part 32.

[3] See American Telephone & Telegraph Co. v. United States, 299 U.S. 232, 238-39 (1936); see also American Telephone & Telegraph Co., Charges for Interstate Telephone Service, Docket 19129 (Phase II), 64 FCC 2d 1, 43 (1977) (Docket 19129 Phase II Order).

[4] See AT&T v. United States, 299 U.S. at 246; Docket 19129 Phase II Order, 64 FCC 2d at 80.

[5] Docket 19129 Phase II Order, 64 FCC 2d at 80; see New York State Dept. of Law v. FCC, 984 F.2d 1209, 1211 (D.C. Cir. 1993).

transactions.[6] Although the specified valuation methods are mandatory for federal accounting purposes, the rules neither regulate the prices at which affiliate transactions occur nor preclude the states from adopting different valuation methods for intrastate regulatory purposes.

5. The affiliate transactions rules distinguish between asset transfers and the provision of services. For asset transfers, the rules provide for four valuation methods: tariffed rates, prevailing company prices, net book cost, and estimated fair market value. Carriers must record each asset transferred to an affiliate pursuant to tariff at the tariffed rate. If an affiliate that is selling a non-tariffed asset has also sold the same kind of asset to a substantial number of third parties at a generally available price, the carrier must record the asset transfer at that prevailing company price. Absent a tariffed rate or prevailing company price, the transfer must be recorded at the higher of net book cost and estimated fair market value when the carrier is the seller, and at the lower of net book cost and estimated fair market value when the carrier is the purchaser.[7]

6. The rules for services provide for three valuation methods: tariffed rates, prevailing company prices, and fully distributed costs. Services provided to an affiliate pursuant to tariff must be recorded at tariffed rates. If the provider of a non-tariffed service also provides substantial amounts of the service to non-affiliates, the carrier must record the service at the price non-affiliates pay, which is also referred to as a prevailing company price. All other affiliate services must be recorded at the providers' fully distributed costs. The rules do not use estimated fair market value as a valuation method for services.[8]

7. When the Commission adopted the affiliate transactions rules, it also adopted standards governing the methods carriers employ to apportion their costs between regulated telephone

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[6] 47 C.F.R. §32.27; see 47 C.F.R. §§64.901, 64.902; Joint Cost Reconsideration Order, 2 FCC Rcd at 6300-01, paras. 154-63; Joint Cost Order, 2 FCC Rcd at 1304-05, paras. 48-49. Thus, the Bell Operating Companies, the GTE Telephone Operating Companies, and about 700 small and mid-sized LECs are subject to the affiliate transactions rules. The Commission exempted average schedule companies because their interstate rates are based on generalized telephone industry data, rather than on each average schedule company's individual costs. See Joint Cost Reconsideration Order, 2 FCC Rcd at 6300, para. 155; see also ICORE, Inc. v. FCC, No. 91-1401 (Feb. 19, 1993).

[7] 47 C.F.R. §32.27(b)-(c).

[8] 47 C.F.R. §32.27(d).

services and nonregulated activities.[9] These standards reflect a fully distributed costing methodology.[10] The costs dominant IXCs and non-average schedule LECs incur for affiliate transactions, like other costs those companies record in USOA accounts, are subject to this regulated/nonregulated apportionment.[11] However, only the American Telephone and Telegraph Company (AT&T) and LECs with annual revenues of $100 million or more are required to file cost manuals detailing their cost apportionment procedures.[12] These manuals must identify each affiliate that engages in transactions with the carrier and describe the nature, terms, and frequency of those transactions.[13]

III. VALUATION METHODS

A. Overview

8. In adopting the affiliate transactions rules, the Commission was attempting to develop a workable system of compensating for the faulty incentives traditional rate of return regulation gives carriers in relation to affiliate transactions. Because those transactions occur at less than arm's length, carriers that are able to pass increases in their costs on to ratepayers may be motivated to pay excessive amounts for assets and services obtained from their nonregulated affiliates. Carriers regulated on a rate of return basis also have incentives to undercharge nonregulated affiliates when the undercharges can be offset by increased charges to ratepayers.

9. The affiliate transactions rules seek to compensate for these faulty incentives by controlling the amounts carriers record in USOA accounts for affiliate transactions. Depending on the circumstances of the transactions, the amounts recorded may reflect

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[9] See 47 C.F.R. §64.901; Joint Cost Order, 2 FCC Rcd at 1318, para. 161.

[10] Joint Cost Order, 2 FCC Rcd at 1299, para. 2; id. at 1312, paras. 109-17.

[11] Bell Atlantic Telephone Companies' Permanent Cost Allocation Manual for the Separation of Regulated and Nonregulated Costs, 5 FCC Rcd 2551, 2551, para. 3 (1990) (Bell Atlantic Review Order).

[12] 47 C.F.R. §64.903(a), (c); Joint Cost Order, 2 FCC Rcd at 1328, para. 236. Although Alascom, Inc. (Alascom) is also a dominant IXC, it is not required to file a cost allocation manual. See Letter from Gerald Brock, Chief, Common Carrier Bureau, FCC, to John D. McGraw, Manager, Tariffs and Regulatory Affairs, Alascom, Inc. (June 23, 1988) (Alascom Letter).

[13] 47 C.F.R. §64.903(a)(4)-(5); Joint Cost Order, 2 FCC Rcd at 1328, para. 240.

the tariff rates, net book costs, fully distributed costs, prevailing company prices, or estimated fair market values applicable to individual assets and services. We have over six years of experience in applying these valuation methods. That experience has let us analyze the bases for and practical effects of the present methods in far greater detail than was possible prior to their adoption. The remainder of this Part sets forth that analysis in detail. Based on that analysis, we believe the present mix of valuation methods may not be optimal for protecting ratepayers against cross-subsidization.

10. Our reasons for believing those methods to be less than optimal derive from the role accounting data play in our overall regulation of dominant IXCs and non-average schedule LECs. To varying extents, those carriers' interstate rates are based on USOA accounting data.[14] When the carriers engage in arm's length transactions, the requirement that carriers record the actual amounts they pay or are entitled to receive helps ensure that the accounting data are reliable.

11. The problem presented by dealings between affiliates is that there are no arm's length transactions to reliably measure how transactions should be valued. Because of this lack, we believe that we should look beyond the prices affiliates pay each other and focus on the costs the affiliate group incurs in providing affiliate transactions.[15] We believe that those costs provide a useful tool for determining the amounts the carrier would have paid

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[14] See Regulatory Reform for Local Exchange Carriers Subject to Rate of Return Regulation, Report and Order, CC Docket No. 92-135, 8 FCC Rcd 4545 (1993) (Regulatory Reform Order). The relationship between accounting data and interstate rates is less direct for price cap carriers than it is for carriers regulated on a traditional, rate of return basis. Nonetheless, affiliate transactions rules assist us in determining price cap carriers' earnings, an important measure of carrier performance under price caps and the key component of the LECs' revenue sharing requirements. See Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, 5 FCC Rcd 6786, 6835, paras. 397-98 (1990) and Erratum, 5 FCC Rcd 7664 (1990) (LEC Price Cap Order), modified on recon., 6 FCC Rcd 2637 (1991), petitions for further recon. dismissed, 6 FCC Rcd 7482 (1991), further modified on recon., 6 FCC Rcd 4524 (1991)(ONA/Part 69 Order), petitions for recon. of ONA/Part 69 Order pending, LEC Price Cap Order affirmed sub nom. National Rural Telecom Ass'n v. FCC, 988 F.2d 174 (D.C. Cir. 1993). See also notes 70-71, infra.

[15] We use "affiliate group" to refer to all entities that directly or indirectly control, are controlled by, or are under common control with a carrier.

or received had it dealt only with non-affiliates.[16] We recognize, however, that cost-based valuation may not produce reasonable results in all circumstances, and we propose to depart from that valuation method when circumstances so warrant. We invite comment on this proposal.

12. In the remainder of this Part, we consider potential departures from cost-based valuation for transactions provided pursuant to tariff, for transactions for which the providing affiliate has established prevailing company prices, and for transactions for which the fair market value differs from the affiliate group's costs. We invite the commenters to address whether the circumstances surrounding these types of transactions warrant departure from cost-based valuation and whether there are any additional circumstances that warrant such a departure.

B. Tariffed Rates

13. The affiliate transactions rules now require carriers to record at tariffed rates affiliate transactions provided pursuant to tariff. Because carriers are obligated to charge tariffed rates for tariffed services, we believe that the relationship between the carrier and the purchasing affiliate is functionally indistinguishable from the relationship between the carrier and other purchasers of the tariffed goods or services. In addition, tariffed rates are subject to federal and state regulation. In these circumstances, we propose to retain our requirement that affiliate transactions provided pursuant to tariff be recorded at tariffed rates.

14. We also propose to treat affiliate transactions as being provided pursuant to tariff only if the tariff is generally available, on file with a federal or state agency, and in effect. Finally, we propose to require all affiliate transactions that meet these three conditions to be recorded at tariffed rates. We invite comment on these proposals.

C. Prevailing Company Prices

1. Introduction

15. A non-tariffed asset or service is deemed to have a prevailing company price whenever the affiliate that provides the asset or service also provides substantial quantities of it to non-affiliates. When such a price exists, the rules require the

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[16] We propose to rely on affiliate group costs, rather than the providing affiliate's costs, because the providing affiliate may have purchased either the transferred item or resources used to produce the transferred item from another affiliate. As with other affiliate transactions, the transfer prices for such purchases do not reliably measure value.

carrier to record the affiliate transaction at that price. We believe that this reliance on prevailing company prices may be inconsistent with how affiliates deal with each other and may unnecessarily burden both this Commission and carriers. In the remainder of this section, we reexamine the reasons for using prevailing company pricing as a valuation method for affiliate transactions. Since we believe that use to be unjustifiable except in limited circumstances, we propose to curtail sharply the rules' reliance on prevailing company pricing. We invite comment on this proposal.

2. Marketplace Considerations

16. In the Joint Cost proceeding, the Commission selected prevailing company prices as a valuation method because it believed that those prices would provide a reasonably reliable measure of fair market value.[17] Our experience in applying the rules has failed to substantiate this belief. Instead, it appears that there may be little correlation between the prices carriers contend are prevailing company prices and the prices carriers or their affiliates would pay if they granted non-affiliates terms similar to those implicit in the affiliate transactions. We believe that this apparent dissimilarity stems from the way the marketplace distinguishes among different supplier/customer relationships.

17. In a competitive market, companies devote extensive resources to retaining and attracting customers. Depending on the nature of the market, these efforts include sales presentations, advertising campaigns, discounts for volume purchases or long-term commitments, and other inducements. Each competitor's goal is to persuade independent entities to pick its goods or services over those of other potential suppliers. A supplier that fails to match its competition risks losing its customers.

18. Affiliate transactions take place in a different environment. Because affiliates are under common control, they are often captive customers of each other. As a result, sales between affiliates usually do not require extensive marketing efforts and generally involve lower transactional costs than sales to non-affiliates. In many instances, moreover, the affiliate relationship reduces the supplier's business risks. Since the customer is more likely to deal with an affiliated than with a non-affiliated supplier, such a relationship can give the supplier a sales guarantee that other suppliers can achieve only through long-term contracts. In these circumstances, we question whether affiliate transactions are sufficiently similar to transactions among non-affiliates to justify the continued use of prevailing company prices as a valuation method for affiliate transactions.

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[17] See generally Joint Cost Reconsideration Order, 2 FCC Rcd at 6296-97; Joint Cost Order, 2 FCC Rcd at 1336.

We invite comment on whether there is such a similarity and, if there is no such similarity, on whether there are other grounds for retaining prevailing company pricing as a valuation method.

19. We also invite comment on whether we should distinguish among classes of nonregulated affiliates in reevaluating prevailing company pricing. In this regard, we note that carrier affiliates appear to fall into two classes: those having a primary purpose to serve the carrier and other affiliates, and those that do not. In our view, dealings between the carrier and nonregulated affiliates in the first group are inherently different from arm's length transactions. As a consequence, we tentatively conclude that we should discontinue prevailing company pricing as a valuation method for transactions between carriers and nonregulated affiliates having a primary purpose to serve the carrier and other affiliates.[18] We invite comment on this tentative conclusion.

20. In contrast, we believe that dealings between the carrier and nonregulated affiliates whose purpose is to serve non-affiliates may possess many of the characteristics of arm's length transactions. We request the commenters to discuss whether this is so and whether there are other distinctions among nonregulated affiliates that we should consider in reevaluating prevailing company pricing. We also invite commenters to describe specific kinds of transactions in which the circumstances suggest that the affiliates are, or are not, dealing at market prices.

21. In theory, the best way to distinguish nonregulated affiliates whose predominant purpose is to serve non-affiliates from other nonregulated affiliates would be to examine each nonregulated affiliate's overall operations in detail. We believe, however, that such examinations would be far too onerous. We also believe that we could approximate the results of such examinations by measuring the percentage of each nonregulated affiliate's total output that is sold to non-affiliates. We further believe that we may use this percentage to establish a "bright line" test for identifying when a nonregulated affiliate's predominant purpose is to serve non-affiliates. Under such a test, a nonregulated affiliate would be deemed to have such a purpose, and thus be eligible for prevailing company pricing, if and only if it sells at least a specified percentage of its output to nonregulated affiliates. We invite the commenters to discuss whether such a test would properly measure when affiliate transactions should be eligible for prevailing company pricing and to suggest alternatives we might use to determine when prevailing company prices reliably measure the value of affiliate transactions.

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[18] Under this approach, the prices the providing affiliate charges non-affiliates could continue to be used to establish fair market value. See para. 92, infra.

22. We also invite comment on the percentage of sales to non-affiliates that we should require nonregulated affiliates to have before their affiliate transactions are eligible for prevailing company pricing. We tentatively conclude that any nonregulated affiliate that sells less than 75 percent of its output to non-affiliates has too large a volume of affiliate transactions to be deemed to have a predominant purpose of serving non-affiliates. Therefore, we propose to continue to allow prevailing company pricing only for affiliate transactions in which the nonregulated affiliate sells at least 75 percent of its output to non-affiliates. We invite the commenters to discuss this proposal as well as alternative percentages we might use. We also invite comment on whether we should abandon prevailing company pricing as a valuation method for all affiliate transactions if we find no workable test for determining when prevailing company prices provide reliable measures of how affiliate transactions should be valued.

D. Fair Market Value

1. Introduction

23. In the Joint Cost proceeding, the Commission adopted two sets of valuation methods for affiliate transactions that are neither tariffed nor subject to prevailing company prices. The Commission required carriers to record asset transfers meeting those criteria at the higher of net book cost and estimated fair market value when carriers are sellers, and at the lower of net book cost and estimated fair market value when carriers are purchasers. In contrast, the Commission required carriers to record all non-tariffed services other than those having prevailing company prices at the providers' fully distributed costs.

24. We have analyzed the bases for and practical effects of these valuation methods. That analysis has confirmed the reasonableness of the departures from cost-based valuation embodied in the present valuation methods for asset transfers that are neither tariffed nor subject to prevailing company prices. Therefore, we propose to retain this approach.[19] Our analysis has also made clear that the present method for services that are neither tariffed nor subject to prevailing company prices may reward the imprudent acts of buying services for more than, and selling services for less than, fair market value. Accordingly,

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[19] In making this proposal, we recognize that our proposal to restrict prevailing company pricing to circumstances in which the nonregulated affiliate sells at least 75 percent of its output to non-affiliates, see paras. 15-22, supra, could increase the instances in which carriers would use either cost or estimated fair market value as a valuation method for asset transfers. Such an increase would occur if carriers were to continue to have the same dealings with affiliates.

we tentatively conclude that we should require carriers to record all non-tariffed affiliate transactions for which we do not permit prevailing company pricing at the higher of cost and estimated fair market value when the carrier is the seller, and at the lower of cost and estimated fair market value when the carrier is the purchaser. We invite comment on this tentative conclusion, which we discuss in detail below.

2. Asset Transfers

25. The present valuation methods for asset transfers that are neither tariffed nor subject to prevailing company prices reflect the Commission's determination in the Joint Cost proceeding that those methods were necessary to keep carriers from shifting costs to regulated activities. The Commission found that because asset transfers between affiliates are generally not arm's length transactions, carriers lacked incentives to maximize sale prices when transferring assets to nonregulated affiliates and to minimize purchase prices when obtaining assets from nonregulated affiliates. To limit the carriers' ability to manipulate asset valuations, the Commission adopted stringent rules for asset transfers that are neither tariffed nor subject to prevailing company prices. These rules require carriers to record all such transfers at the higher of net book cost and estimated fair market value when carriers are sellers, and at the lower of net book cost and estimated fair market value when carriers are purchasers.[20]

26. We believe that this antipodal approach is necessary to deter improper cost shifting and to avoid rewarding carrier imprudence. Since asset transfers between affiliates generally occur at less than arm's length, there is no assurance that the prices the affiliates set approximate market values. The rules restrict the ability of the affiliate group to profit from price manipulation by establishing net book cost as a valuation floor for assets the carrier sells nonregulated affiliates and as a valuation ceiling for assets the carrier purchases from nonregulated affiliates. We tentatively conclude that we must retain this floor and ceiling if we are to continue to protect ratepayers against cost shifting. We invite comment on this tentative conclusion.

27. The rules also mandate that carriers record asset sales to nonregulated affiliates at estimated fair market value whenever it exceeds net book cost and asset purchases from nonregulated affiliates at estimated fair market value whenever it is less than net book cost. We believe that these departures from cost-based valuation are necessary to deter improper cost shifting and to avoid rewarding carrier imprudence. When a carrier sells assets

[20] Joint Cost Reconsideration Order, 2 FCC Rcd at 6295-96, paras. 109-17; Joint Cost Order, 2 FCC Rcd at 1336, paras. 295-98.

to non-affiliates, it has every incentive to obtain at least fair market value. Our accounting and net income rules require that any gain above net book cost be recorded in USOA accounts and be included in net income to the extent the assets were included in the interstate rate base.[21] Our valuation methods for asset sales ensure that ratepayers receive an equivalent gain when the carrier deals with its nonregulated affiliates.

28. Similarly, a carrier would also be acting imprudently if it paid more than fair market value for assets purchased from nonregulated affiliates. Our rules reflect this by requiring that the amounts recorded in USOA accounts for asset purchases not exceed what the carrier would have paid in arm's length transactions. We believe that this valuation method is necessary to avoid ratifying the carrier's imprudent acts. We, therefore, tentatively conclude that the departures from cost-based accounting embodied in the present valuation methods for asset transfers are reasonable to the extent they mandate that transactions be recorded at estimated fair market value. We also tentatively conclude that we should continue to require all non-tariffed affiliate asset transfers for which we do not permit prevailing company pricing to be recorded at the higher of net book cost and estimated fair market value when a carrier is the seller, and at the lower of net book cost and estimated fair market value when a carrier is the purchaser. We invite comment on these tentative conclusions.

29. Although our proposals for asset transfers could increase the circumstances in which carriers and their affiliates would have to deal with non-affiliates in order to obtain fair market value on asset sales,[22] we do not believe that this provides any reason for not implementing those proposals. Our proposal to restrict prevailing company pricing to transactions involving nonregulated affiliates that sell at least 75 percent of their output to non-affiliates is based on our belief that affiliate transactions take place in a different environment from arm's length transactions. If that belief is accurate, we believe that we must at least restrict the availability of prevailing company pricing. We believe, in addition, that we should apply our present methods for non-tariffed asset transfers that are ineligible for prevailing company pricing to all asset transfers that would become ineligible under our proposals.[23] The need for such application, in our view,

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[21] See, e.g., 47 C.F.R. §§32.7160; 65.450.

[22] See note 19, supra.

[23] Thus, if we completely abandon prevailing company prices as a valuation method, we propose to require all non-tariffed asset transfers between carriers and their nonregulated affiliates to be recorded at the higher of net book cost and estimated fair market value when a carrier is the seller, and at the lower of net book cost and estimated fair market value when a carrier is the purchaser.

would override any potential adverse effects those methods might have on carrier incentives to engage in affiliate transactions.[24] We invite comment on these matters.

3. Services

30. In the Joint Cost proceeding, the Commission proposed identical valuation methods for assets and services. These methods would have required carriers to record all affiliate transactions that are neither tariffed nor subject to prevailing company prices at the higher of cost and fair market value when carriers are the sellers, and at the lower of cost and fair market value when carriers are the purchasers.[25] While the Commission applied these methods to asset transfers, the Commission adopted a different method for services. Under this method, carriers must record affiliate transactions consisting of the provision of services that are neither tariffed nor subject to prevailing company prices at the providers' fully distributed costs.[26]

31. The Commission's reason for not applying the asset transfer rules to services was that commenters had suggested that those rules would reduce or eliminate "the incentive for certain service activities to be provided in a more efficient manner than that which the regulated entity would alone achieve."[27] We believe that developments since the adoption of the affiliate transactions rules have undermined this rationale. The affiliate transactions rules took effect on April 3, 1987.[28] Since that date, we have adopted price cap regulatory programs that give AT&T[29] and most large LECs[30] efficiency incentives far stronger than those the valuation methods for affiliate services sought to preserve. Other

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[24] Compare Southwestern Bell Corp. v. FCC, 896 F.2d at 1381; Joint Cost Reconsideration Order, 2 FCC Rcd at 6296, para. 117.

[25] Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities, Notice of Proposed Rulemaking, CC Docket No. 86-111, 104 FCC 2d 59, 76 & 115 (1986).

[26] See Joint Cost Order, 2 FCC Rcd at 1336, para. 299.

[27] Id. at 1336, para. 294.

[28] New York State Dept. of Law v. FCC, 984 F.2d at 1211, n.1.

[29] Policy and Rules Concerning Rates for Dominant Carriers, Report and Order, and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd 2873 (1989) (AT&T Price Cap Order), recon., 6 FCC Rcd 665 (1991) (AT&T Price Cap Recon. Order), remanded on other grounds sub nom. AT&T v. FCC, 974 F.2d 1351 (D.C. Cir. 1992).

[30] LEC Price Cap Order, 5 FCC Rcd at 6787, paras. 1-4.

LECs may attain similar incentives by electing either price cap regulation or optional incentive regulation.[31]

32. These changes in overall regulatory approach have caused us to reevaluate the effect of our valuation methods for affiliate services on carrier incentives. That reevaluation has made clear that, instead of motivating carriers to operate efficiently, the present valuation methods for affiliate services reward imprudent carrier conduct. By requiring carriers to record services they sell to nonregulated affiliates at the carriers' fully distributed costs even when those costs are less than what non-affiliates would pay the carriers, the rules motivate carriers to sell services for less than fair market value. Similarly, by permitting carriers to record services purchased from nonregulated affiliates at the affiliates' fully distributed costs even when those costs exceed what the carriers would pay non-affiliates, the rules motivate carriers to pay more than fair market value for services. We believe that these motivations are at odds with the incentives toward increased carrier efficiency that our price cap and optional incentive regulation programs were designed to promote. As a consequence, we tentatively conclude that, far from supporting the present valuation method for services that are neither tariffed nor subject to prevailing company prices, efficiency incentives provide a basis for abandoning that methodology. We invite comment on this tentative conclusion.

33. We recognize that some commenters may dispute our analysis and argue that the present valuation method has increased overall carrier efficiency. We invite commenters to discuss how, if at all, it might increase carrier efficiency to sell services to nonregulated affiliates for less than fair market value or to buy services from nonregulated affiliates for more than fair market value.[32] We are particularly interested in whether there are any instances in which carriers believe they have increased their overall efficiency by obtaining services from nonregulated affiliates at amounts exceeding the services' fair market value or by selling services to nonregulated affiliates at amounts less than the services' fair market value. We ask commenters to list any specific services that they believe have had such effects and to explain in detail how recording them at the affiliates' fully distributed costs, rather than the services' fair market value, increased carrier efficiency.

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[31] See Regulatory Reform Order, 8 FCC Rcd at 4555-56, paras. 67-71; LEC Price Cap Order, 5 FCC Rcd at 6818-19, paras. 262-65.

[32] The Commission made no finding on this matter in adopting the present valuation methods. See Joint Cost Order, 2 FCC Rcd at 1336, para. 299; see also Joint Cost Reconsideration Order, 2 FCC Rcd at 6297-98, paras. 130-35.

34. In our discussion of asset transfers,[33] we tentatively conclude that we must retain net book cost as a valuation floor for assets the carrier sells nonregulated affiliates and as a valuation ceiling for assets the carrier purchases from nonregulated affiliates if we are to continue to protect ratepayers against cost shifting. That discussion also tentatively concludes that we must depart from this cost standard when cost exceeds fair market value and the carrier is the seller, and when cost is less than fair market value and the carrier is the purchaser. We believe that the reasoning behind these tentative conclusions is equally applicable to service transactions. Therefore, we tentatively conclude that we should require carriers to record all affiliate transactions involving the provision of services, other than those provided pursuant to tariff or permitted to be recorded at prevailing company prices, at the higher of fully distributed costs and estimated fair market value when a carrier is the seller, and at the lower of fully distributed costs and estimated fair market value when a carrier is the purchaser.[34] We invite comment on this tentative conclusion.

E. Other Valuation Method Issues

1. Effect of Valuation Method Changes on Price Caps

35. The price caps systems the Commission adopted for AT&T and the LECs rely on indexes of the costs applicable to individual baskets of tariffed services. These indexes are adjusted each year to reflect inflation in the general economy, productivity growth in the telephone industry, and consumer productivity dividends. The Commission also provided for adjustments in these indexes to reflect cost changes that are beyond the carriers' control and not reflected in the general inflation and productivity growth adjustments. These cost changes are described as "exogenous."[35]

36. The valuation methods we propose in this Notice would change the USOA requirements for affiliate transaction accounting. In the price cap proceedings, the Commission determined that

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[33] See paras. 25-29, supra.

[34] In paragraphs 40-81, infra, we address in detail how these costs would be calculated.

[35] See 47 C.F.R. §§61.44(c)(2), 61.45(d)(1)(ii); see Treatment of Local Exchange Carrier Tariffs Implementing Statement of Financial Accounting Standards, "Employers Accounting for Postretirement Benefits Other Than Pensions," Memorandum Opinion and Order, CC Docket No. 92-101, 8 FCC Rcd 1024, 1025-26, paras. 7-11 (1993).

changes to the USOA should generally be treated as exogenous.[36] In view of that determination, we tentatively conclude that any changes we make in the valuation methods for affiliate transactions should be exogenous. We invite comment on this tentative conclusion.[37]

2. Deviation from Specified Valuation Methods

37. In the exercise of its delegated authority, our Common Carrier Bureau (Bureau) has on numerous occasions addressed proposed valuation methods that deviated from those set forth in the affiliate transactions rules. The Bureau has generally rejected these proposals.[38] The sole exception to this general policy has been for services carriers sell to nonregulated affiliates that carriers propose to record at their affiliates' fully distributed costs plus a subsidy to the carriers. Because of an absence of any apparent harm to ratepayers, the Bureau has approved such proposals.[39]

38. This Notice proposes four valuation methods for affiliate transactions: tariffed rates, prevailing company prices, costs, and estimated fair market value. Although we believe that deviations from these valuation methods generally should be prohibited, we tentatively conclude that we should allow alternative valuation methods that reduce regulated costs. We invite comment on this tentative conclusion.

39. We also believe that merely characterizing the

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[36] 47 C.F.R. §61.44(c)(2) (USOA changes exogenous for AT&T price cap purposes); 47 C.F.R. § 61.45(d)(1)(ii) ("[s]ubject to further order of the Commission," USOA changes exogenous for LEC price cap purposes); see also LEC Price Cap Order, 5 FCC Rcd at 6807, para. 166; AT&T Price Cap Order, 4 FCC Rcd at 3017-18, paras. 294-95;

[37] In para. 109, infra, we invite the commenters to quantify the impact each of the proposed methods would have on regulated operations.

[38] See, e.g., Nevada Bell's and Pacific Bell's Permanent Cost Allocation Manuals for the Separation of Regulated and Nonregulated Costs, 3 FCC Rcd 7081, 7083, para. 20-21 (Com. Car. Bur. 1988) (Nevada and Pacific Compliance Order) ("prices 'charged in accordance with a market rate determined by nonaffiliated, third party brokers'"); NYNEX Telephone Companies' Permanent Cost Allocation Manual for the Separation of Regulated and Nonregulated Costs, 3 FCC Rcd 81, 84, para. 26 (Com. Car. Bur. 1988) ("'[m]arket equivalent prices'") (NYNEX Order).

[39] Local Exchange Carriers' Permanent Cost Allocation Manuals for the Separation of Regulated and Nonregulated Costs, 8 FCC Rcd 3105, 3107, para. 16 (Com. Car. Bur. 1993); U S West's Permanent Cost Allocation Manual for the Separation of Regulated and Nonregulated Costs, 4 FCC Rcd 481, 484-86, paras. 35-42 (Com. Car. Bur. 1989) (U S West Compliance Order).

differential between the method prescribed in the rules and the carrier's proposal as a "subsidy" to the carrier may be insufficient. For instance, when a carrier sells a product to a nonregulated affiliate under a "subsidy" arrangement, both the carrier's "revenue" and the nonregulated affiliate's "costs" for the transaction are higher than they otherwise would be. If the carrier were to record the extra revenue below-the-line,[40] the interstate ratepayers would receive no direct benefit (or harm) from the "subsidy." The nonregulated affiliate, however, could use the product to supply the carrier with a second product that the carrier, in turn, would use to support its regulated activities. If the carrier were to record this second product at the nonregulated affiliate's "cost," the "subsidy" arrangement would result in an increase in regulated costs. We believe that the possibility of such indirect increases militates against any blanket approval for "subsidy" arrangements.[41] We ask the commenters to address how we can avoid such increases while allowing valuation methods that reduce interstate costs.[42]

IV. IMPLEMENTATION

A. Costs to the Affiliate Group

1. Overview

40. The valuation methods we propose in Part III of this Notice would require carriers to record certain affiliate transactions at their costs to the affiliate group. Determining those costs involves several steps. It requires an accounting system that records what the affiliate group originally paid for the equipment and other resources used to provide affiliate transactions. Since some of those resources are also used for other purposes, there must be a means for determining the portion of the costs that is used for affiliate transactions. It may also be necessary to specify a rate base methodology, a rate of return the group can earn on the rate base, and an allowable expense methodology.

41. In the remainder of this Section, we propose specific requirements for this costing process. These proposals generally would make carriers calculate affiliate transactions costs using

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[40] Amounts recorded below-the-line are excluded from interstate costs.

[41] In the arrangements approved by the Bureau, the records made clear that these indirect increases would not occur.

[42] Our proposals would not preclude carriers and their officials from transferring funds among affiliates as long as the transfers do not affect carrier operating expenses.

methods similar to those we require carriers to use in calculating interstate costs. We are proposing this approach because we believe compliance with our rules for calculating interstate costs should not be dependent on the corporate structures through which carriers choose to conduct their operations.

42. The costing methods we propose would apply primarily, if not exclusively, to transactions provided by carriers and those of their nonregulated affiliates that have serving carriers and other affiliates as a primary purpose. We believe that these nonregulated affiliates' principal role is to support telecommunications services, either through dealings with affiliated carriers or through transactions with other affiliates that also deal extensively with the carriers. We also believe that carriers themselves could supply all the resources they obtain from these nonregulated affiliates. While we do not intend to dictate how carriers structure their operations, the choice of structure should not result in the inclusion of otherwise impermissible items in interstate costs. In these circumstances, we believe that the costing methods we propose are well within our discretion and may be necessary to prevent unreasonably high interstate costs.

43. We recognize, of course, that the costing methods we propose for affiliate transactions would impose burdens on carriers. We ask the commenters to quantify the costs and benefits of each of our proposals, and to suggest alternatives that may reduce costs or increase benefits. We also invite the commenters to address whether each of our proposals would be the most cost-effective alternative for protecting ratepayers against improper cross-subsidization and carriers' imprudent acts.

2. Cost Determination

a. Overall Method

44. The affiliate transactions rules present separate costing methods for assets and services. For asset transfers, the rules specify that costs shall equal "cost less all applicable valuation reserves" when the carrier is the seller[43] and "cost to the originating activity [of] the affiliated group less all applicable valuation reserves" when the carrier is the buyer.[44] For service transactions, the rules specify that cost shall be determined in accordance with the standards and procedures that carriers must use to apportion their costs between regulated and nonregulated activities.[45] Those standards and procedures reflect a form of

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[43] 47 C.F.R. 32.27(c).

[44] 47 C.F.R. 32.27(b).

[45] 47 C.F.R. 32.27(d).

fully distributed costing that apportions costs in accordance with their causes.[46]

45. Because we propose identical valuation methods for all types of affiliate transactions,[47] we believe that separate costing methods for assets and services may no longer be necessary. As explained below, we propose a costing method that would eliminate the distinction between assets and services now in the affiliate transactions rules. We believe that this method is consistent with how carriers and their nonregulated affiliates keep their accounts, and would provide more accurate costing results than any alternative method. We invite comment on whether these beliefs are correct and on each aspect of this costing method.[48]

46. Some affiliate transactions involve resources that the transferring entity has recorded in an investment account. We propose to require carriers to record as the cost of each such resource an amount equal to the original cost of that resource to the affiliate group less any accumulated depreciation and other associated reserves. When the provider obtained the resource directly from a non-affiliate, the original cost would equal the amount the provider paid the non-affiliate for the resource plus any costs the provider incurred in obtaining the resource from the non-affiliate.

47. Affiliate transactions also involve resources that the provider has recorded in an expense account. When the provider obtained these resources directly from a non-affiliate, we propose to require that their original cost equal the amount the provider paid the non-affiliate for the resource plus any costs the provider incurred in obtaining the resource from the non-affiliate.

b. Chain Transactions

48. In some instances, affiliate transactions involve resources that the provider obtained from another member of the affiliate group. For example, a nonregulated affiliate might purchase supplies from another nonregulated affiliate and then sell them to an affiliated carrier. The nonregulated affiliate that purchases the supplies could also use them to make products that it sells to the carrier or other affiliates. These products, in turn, could be transferred among affiliates or used to make

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[46] 47 C.F.R. 64.901; see also Joint Cost Order, 2 FCC Rcd at 1318-20, paras. 161-72.

[47] See para. 34, supra.

[48] To ensure a complete record, we also invite comment on how we should define "assets" and "services" if we continue to distinguish between those two kinds of transactions.

additional products that are transferred among affiliates.

49. In such chain transactions, we propose to require carriers to calculate the costs of resources obtained from other affiliates in accordance with the valuation methods proposed in this Notice. Under this approach, carriers would continue to trace resources used in affiliate transactions to determine whether the resources had been transferred between or among affiliates prior to the transactions.[49] Resources that had been previously transferred would then be valued at the transferor's tariffed rates, prevailing company prices, fully distributed costs, or estimated fair market value for purposes of determining the costs of future affiliate transactions.[50] We believe that this tracing may be necessary to achieve our goal of protecting ratepayers against cross-subsidization and would not unnecessarily burden carriers or this Commission.

50. Alternatively, we could require that all resources used in affiliate transactions be valued at their original cost to the affiliate group regardless of whether they had previously been transferred between or among affiliates. We invite the commenters to compare the costs and benefits of these two approaches to chain transactions, and to suggest alternative approaches that would maximize overall benefits while minimizing costs.

c. Compliance with Generally Accepted Accounting Principles

51. Although dominant IXCs and non-average schedule LECs must comply with the affiliate transactions rules, this Commission has subjected neither connecting carriers[51] nor nonregulated affiliates to other portions of the USOA. To ensure that the costing process

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[49] See NYNEX Telephone Companies' Permanent Cost Allocation Manual for the Separation of Regulated and Nonregulated Costs, 3 FCC Rcd 5978, 5980-81, paras. 21-25 (Com. Car. Bur. 1988) (NYNEX Compliance Order).

[50] An example might help illustrate this process. Assume that a nonregulated affiliate (A) sells an item to another nonregulated affiliate (B) and that B, in turn, sells the item to an affiliated carrier without adding value to it. Also assume that A had established a prevailing company price for the item and that B is ineligible for prevailing company pricing. In these circumstances, the carrier would record its transaction with B at A's prevailing company price less any reserves B had properly associated with the item. In the absence of such a price, the carrier would record that transaction at the lower of A's cost as calculated in accordance with our proposals plus any costs B incurred in handling the item and the item's estimated fair market value as of the transfer to the carrier.

[51] Connecting carriers are those LECs described in Section 2(b)(2)-(4) of the Communications Act of 1934, as amended, 47 U.S.C. §152(b)(2)-(4).

is based on reliable data, we propose that, except as otherwise ordered by this Commission, all accounting related to affiliate transactions must comply with generally accepted accounting principles (GAAP). Under this approach, unless otherwise ordered by the Commission, fully subject carriers would have to use costs recorded in accordance with GAAP in calculating nonregulated affiliates' costs. Connecting carriers that are subject to the affiliate transactions rules, but not to other portions of the USOA,[52] would have to use costs recorded in accordance with GAAP in calculating both their costs and their nonregulated affiliates' costs.

d. Accumulated Depreciation and Other Reserves

52. The definition of cost we propose would require carriers to determine the cost of a resource by deducting accumulated depreciation from the resource's original cost.[53] We propose to require that accumulated depreciation amounts reflect any depreciation prescription by this Commission that applies to the transferred resource. When no such prescription applies, we propose to require that these amounts be consistent with GAAP.

53. Our proposed definition of cost would also require that the transferred resource's cost reflect any other reserves associated with a resource.[54] We believe that these other reserves should consist of deferred taxes, unamortized investment tax credits, and depletion allowances, as applicable. We invite comment on whether these reserves should be included in carriers' cost calculations and whether there are other reserves that should also be included.

3. Cost Apportionment

54. Affiliate transactions can involve either the transfer of resources, the use of resources, or both. To the extent a transaction involves a transfer of a resource that our valuation methods require to be recorded at cost, we propose that the carrier record the transaction at the cost to the affiliate group, as defined above. To the extent a transaction involves the use of a resource, we propose that the carrier determine the resource's cost in accordance with the standards and procedures promulgated in the Joint Cost proceeding for apportioning carrier costs between regulated and nonregulated activities.[55] Those standards and

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[52] See Joint Cost Reconsideration Order, 2 FCC Rcd at 6301, paras. 160-63.

[53] See para. 46, supra.

[54] Id.

[55] 47 C.F.R. 32.27(d).

procedures reflect a form of fully distributed costing that requires carriers to apportion costs in accordance with cost causality.[56]

55. We invite comment on how precise we should require this apportionment process to be. For instance, when a carrier uses a digital switch to provide both regulated and nonregulated activities, our cost apportionment standards require the carrier to apportion the switch's cost between regulated and nonregulated activities in accordance with the peak nonregulated usage forecast for a three-year period.[57] If the switch is used to provide nonregulated services to both affiliates and non-affiliates, our existing rules require a further apportionment of the nonregulated costs between affiliate transactions and third party transactions. There might have to be additional apportionments if some of the affiliate transactions were to be recorded at fully distributed costs and others at prevailing company prices or estimated fair market value. We ask that the commenters address whether each of these steps needs to be performed with equal exactitude.

56. Similarly, when a nonregulated affiliate uses its equipment in transactions with both an affiliated carrier and non-affiliates, the existing rules contemplate an apportionment of the nonregulated affiliate's costs between affiliate transactions and third party transactions. The rules also contemplate that the costs apportioned to affiliate transactions will be further apportioned between those affiliate transactions that are to be recorded at prevailing company prices and those that are to be recorded at cost. Another apportionment might also be necessary to ensure that the total costs of those transactions that are to be recorded at cost are properly apportioned among USOA accounts. We invite comment on whether these additional apportionments should be retained.

4. Allowable Costs

a. Overview

57. Regulators, including this Commission, have traditionally computed carrier revenue requirements by means of the following formula:

Revenue Requirements = ((Rate Base) x (Rate of Return)) + Expenses.

The Commission has adopted rate base and expense methodologies and

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[56] 47 C.F.R. 64.901; see also Joint Cost Order, 2 FCC Rcd at 1318-20, paras. 161-72.

[57] See Joint Cost Reconsideration Order, 2 FCC Rcd at 6287-90, paras. 36-46 & 53-57.

prescribed a rate of return for carriers to use in computing interstate revenue requirements. We propose to require carriers to calculate the costs of those affiliate transactions that must be recorded at cost in accordance with similar rate base and expense methodologies, and using an equivalent rate of return, as described below.

b. Rate Base

58. To help ensure compliance with our rate base requirements, the Commission staff has developed a generic rate base methodology for AT&T and LECs with annual revenues of at least $100 million to use in determining the fully distributed costs of services nonregulated affiliates provide carriers. Under this methodology, a nonregulated affiliate's rate base equals:

* Property, plant, and equipment; plus
* Deferred charges and other assets; plus
* Cash working capital; less
* Accumulated depreciation, accumulated deferred income taxes, and other deferred credits.

The generic methodology requires AT&T and LECs meeting the $100 million criterion to calculate these components using the 13-month average of the net investments that the nonregulated affiliate reports on monthly financial statements. In calculating that average, the carrier must assume that all of the affiliate's property, plant, and equipment is used and useful.[58]

59. Although we believe that we should adopt a rate base methodology for carriers to use in determining the costs of transactions nonregulated affiliates provide carriers, we are concerned that the methodology described above may overstate affiliate transactions costs. We propose to modify that methodology to ensure that it does not lead to the inclusion of improper items in interstate costs. We invite comment on this proposal, which is set forth below.

60. Our concerns regarding the existing rate base methodology for affiliate transactions arise from its treatment of several classes of items that our rules require carriers to exclude from the interstate rate base. First, the assumption that all of the affiliate's property, plant, and equipment is used and useful is

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[58] E.g., Letter from Jose-Luis Rodriguez, Chief, Audits Branch, Accounting and Audits Division, Common Carrier Bureau, to Fred Konrad, Director - Federal Regulatory Matters, Ameritech Corporation, at 3-4 (Apr. 20, 1992).

inconsistent with our restriction of the interstate rate base to investment in used and useful plant.[59] Since this inconsistency could lead to the inclusion of nonproductive investment in interstate costs, we propose to exclude investment in property, plant, and equipment that is not used and useful from the affiliate transactions rate base.

61. Second, the generic methodology permits rate base treatment of all investment in construction projects. We are concerned that this treatment is inconsistent with both our current and our proposed policies regarding such projects. Under our current policy, carriers may include investment in construction projects in the interstate rate base only if the projects are designed to be completed in less than one year. Investment in other construction projects must be excluded from the interstate rate base. However, to compensate for this exclusion, we permit carriers to include an allowance for funds used during construction (AFUDC) in the computation of the original cost of the completed construction.[60]

62. We recently proposed to change these policies with regard to carrier construction projects. Under our proposals, carriers would include all investment in plant under construction in the interstate rate base, but capitalize AFUDC at the cost of debt and deduct capitalized AFUDC from the interstate revenue requirements for the period in which it is capitalized.[61] In view of the pendency of this AFUDC proceeding, we propose to permit carriers to include investment in plant under construction in affiliate transactions costs to the extent permitted and subject to whatever conditions we adopt for the interstate rate base.

63. Third, carriers may be assuming that the generic methodology permits inclusion of noncurrent assets, such as unamortized debt issuance expense, that we exclude from the interstate rate base.[62] Carriers may also believe that the generic methodology permits the automatic inclusion of other noncurrent assets, such as preliminary survey costs for contemplated construction projects and deferred maintenance and retirement charges, that carriers may include in the interstate rate base only

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[59] 47 C.F.R. §65.800.

[60] See 47 C.F.R. §§32.2000(c)(2)(x), 32.2003, 65.820; Accounting and Ratemaking Treatment for the Allowance for Funds Used During Construction (AFUDC), Notice of Proposed Rulemaking, 8 FCC Rcd 2084 (1993). For interstate ratemaking purposes, AFUDC must generally be computed at the prime rate. See id. at 2084-85, paras. 2-7.

[61] Id. at 2086-87, para. 17 (1993).

[62] 47 C.F.R. §65.820(c); see also 47 C.F.R. §§32.1401 to 32.1500.

pursuant to our specific approval.[63] To eliminate these problems, we propose to make clear that carriers may include noncurrent assets in affiliate transactions costs only to the extent we permit such assets to be included in the interstate rate base.

64. Fourth, carriers using the generic methodology also may not be deducting customer deposits and unfunded accrued pension costs from the affiliate transactions rate base, even though our rules require such items to be deducted from the interstate rate base.[64] We propose that these items also be deducted from the rate base used to calculate affiliate transactions costs.

65. We propose to require all carriers subject to the affiliate transactions rules to comply with the methodology proposed above, in determining the costs of those affiliate transactions that our proposed valuation methods would require them to record at cost.[65] We invite comment on this proposal and on whether we should modify the existing methodology in other respects. We also invite comment on whether we should modify the proposed methodology to reduce burdens on small and mid-sized carriers.

c. Return Component

66. In the Joint Cost proceeding, the Commission determined that fully distributed costs should include a return on investment, but no "profit" in excess of the allowed return.[66] In accordance with this determination, the Bureau has required non-average schedule LECs and dominant IXCs to use the prescribed, interstate rates of return in determining this return component, absent specific authorization to the contrary.[67] The most recently prescribed, interstate rate of return for LECs is 11.25 percent.[68]

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[63] 47 C.F.R. §65.820(c); see also 47 C.F.R. §§32.1402, 32.1410, 32.1438, 32.1439.

[64] 47 C.F.R. §65.830(a).

[65] We note that para. 101, infra, invites comment on whether AT&T should be subject to each aspect of our proposals for large LECs.

[66] Joint Cost Reconsideration Order, 2 FCC Rcd at 6296, para. 119, 6298, para. 133, & 6315, n.203.

[67] See Contel Corporation Telephone Operating Companies' Permanent Cost Allocation Manual for the Separation of Regulated and Nonregulated Costs, 4 FCC Rcd 2150, 2151, para. 7 (Com. Car. Bur. 1989) (Contel Compliance Order).

[68] Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, Order, 5 FCC Rcd 7507 (1990), recon. denied, 6 FCC Rcd 7193 (1991), aff'd sub nom. Illinois Bell Telephone Co. v. FCC, No. 91-1020